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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Price Cap Regulation of Local Exchange Carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing And Lower Formula Adjustment	)	

COMMENTS OF GTE

GTE Service Corporation and
its affiliated domestic
telephone operating companies

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GTE Service Corporation and its affiliated domestic telephone operating companies ("GTE") offer their comments in response to the Commission's proposal to incorporate the "add-back" adjustment into the Commission rules as set forth in the above-captioned Notice of Proposed Rulemaking ("NPRM" or "Notice"), FCC 93-325 (released July 6, 1993).

INTRODUCTION

The Commission's price cap plan[1] became applicable to Tier 1 Local Exchange Carriers ("LECs" or "exchange carriers"), including GTE, for the 1991 calendar year.

In the annual 1993 access tariff filing an issue arose as to how sharing and lower formula ("LFAM") adjustments in the Price Cap Index ("PCI") should be "reflected in the rate of return used to determine sharing and [LFAM] in the following year."[2] Upon reviewing its rules, the Commission determined that this issue was "neither expressly

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1 Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313 ("D.87-313"), Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989), and Erratum, 4 FCC Rcd 3379 (1989), ("*D.87-313 Report & Order*"), Second Report and Order, 5 FCC Rcd 6786 (1990), and Erratum, 5 FCC Rcd 7664 (1990), ("*LEC Price Cap Order*"), *modified on recon.*, 6 FCC Rcd 2637 (1991) ("*LEC Price Cap Reconsideration Order*"), *aff'd. sub nom.* National Rural Telecom Association, 988 F.2d 174 (D.C. Cir. 1993)

2 NPRM at paragraph 3.

discussed...nor clearly addressed...."[3] Now the Notice (at paragraph 15) proposes to revise the exchange carrier price cap rules to specifically require sharing and LFAM to be computed employing the "add-back" methodology used to compute refunds under rate of return regulation.

DISCUSSION

1. The premise of the Notice, that the sharing backstop was designed to operate in much the same way as rate of return regulation, is simply incorrect.

GTE urges the Commission to put aside the tentative conclusions and proposals of the Notice because, to start with, they are grounded in the mistaken premise set out in paragraph 8 of the Notice:

> We anticipated that the [sharing] backstop would operate in much the same way as rate of return enforcement for LECs still subject to rate of return regulation.

This statement should come as a complete surprise to those who followed the Commission's adoption of price caps. The whole point of the Commission's policy was to avoid the inefficiencies and distorting effects of rate of return regulation. The sharing mechanism was developed as a backstop to protect both the public and the company by a one-time adjustment to the PCI for the following year without compromising the whole purpose of incentive regulation.

In the course of discussing sharing, the Commission made it absolutely clear that the sharing device was designed to result in changes in the PCI. For example: "[T]he sharing mechanism operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings...."[4] And: "[W]e conclude that sharing should be implemented by adjustments to the next year's PCI."[5]

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[3] NPRM at paragraph 4.

[4] *LEC Price Cap Order,* 5 FCC Rcd at 6803.

[5] *Id.*, 5 FCC Rcd at 6805.

This sharing backstop was never intended to defeat the core of the price caps plan -- which is precisely what would result from turning sharing into a reinvention of the very system the Commission was trying to escape -- "operat[ing] in much the same way as rate of return enforcement for LECs still subject to rate of return regulation."

In summary: The Notice is grounded on an erroneous premise.

2. Based on this false premise, the proposals of the Notice would produce results directly contrary to the Commission's plan.

In 1989, the Commission said: "Our interest in formulating an alternative regulatory approach for dominant carriers stems directly from our concern with the drawbacks of rate of return regulation."[6] Measuring alternative regulatory methods against the rate of return system, the Commission identified five flaws in rate of return regulation: (1) it provides incentives for carriers to be inefficient; (2) it provides carriers with insufficient incentives to encourage innovation; (3) it tends to foster cross-subsidization and inability to move toward an optimally efficient set of prices; (4) its administrative costs are high; and (5) consumers are better off under incentive regulation than under rate of return regulation.[7]

The intended effect of incentive regulation is to encourage efficiencies that will redound to the benefit of both carrier and ratepayer. Under incentive regulation, it is no longer correct to speak of "overearnings." If a carrier can meet its formidable

There is not a trace of a sign of a suggestion in the relevant orders that when the Commission created the sharing backstop in 1990 it was reintroducing a system that would "operate in much the same way as rate of return enforcement for LECs still subject to rate of return regulation." This would have meant an abandonment of the objectives the Commission had articulated so carefully -- objectives the Commission continued to rely on even as it introduced the sharing backstop. The sharing device was carefully described as simply a "backstop"[9] -- not as an inversion of the entire plan and a return to the very irrationalities the plan was constructed to escape.

This profound misconception, which permeates the Notice, twists incentive regulation into something totally different from its clearly stated intent. This is shown explicitly in the Notice's Appendix A, which sets out three sets of calculations that illustrate the impact of the "add-back" proposals of the Notice. Then Appendix A says:

> Thus [under the proposals of the Notice] the company which includes the add-back in its rate of return computation has the same rate of return and returns the same amount of money to ratepayers as the company which makes its refund by a check.

This language and the accompanying calculations make the point explicit: What is being proposed are rule modifications that would essentially change the whole character of the Commission's plan. The express purpose of the NPRM proposals as shown in Appendix A -- which in turn is grounded on the false premise addressed *supra* -- is to produce the same effect as if the sharing provision of the FCC's incentive regulation plan were a refund provision.

This is further illustrated in paragraph 16 of the Notice, where the Commission asks "whether a LEC that has set its rates below the price cap indexes during the base year should receive credit for the amount between its PCI and its API, or actual prices,

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9 *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2683-84; *LEC Price Cap Order*, 5 FCC Rcd at 6801.

in calculating its sharing amounts." The raising of this question indicates grave confusion about the nature of the Commission's plan and how it was designed to work.

Central to an understanding of incentive regulation is that a change in the PCI is not the same thing as a refund. The PCI operates as a prospective cap on rates; it does not set rates, either prospectively or retroactively. A PCI change may operate in either direction, favorably to the company or favorably to the ratepayer. Then, when the cap has been adjusted, whether rates under the price cap are increased or decreased depends on the existing level of rates, on whether market realities permit or dictate upward or downward rate changes, and on the judgment of company management. Thus, the PCI comes into play as a cap on future pricing, not current pricing. And in the case of an exchange carrier like GTE which has often priced below its PCI, a PCI adjustment may have no effect whatever even on prospective pricing.

To speak of "a credit for the amount between [the carrier's] PCI and its actual prices" indicates a misunderstanding of the entire process. If the system is properly understood, the question of such a credit never arises. A PCI adjustment is one factor in a formula; whether it has any effect at all on the pricing of a particular carrier's services depends on the working out of the Commission's formula. A PCI adjustment may lead to reduced carrier rates in the following year -- provided that is the result established by application of the Commission's formula in light of the facts of the case. And the facts of the case include the carrier's actually existing level of rates, which are reflected in its API.

The PCI may lead to a downward adjustment in rates or an upward adjustment in rates, but it never leads to a refund. This point is reinforced by a keystone principle of public utility regulation that prohibits retroactive refunds.[10] The PCI adjustment as

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[10] Illinois Bell Tel. Co. v. FCC, 966 F.2d 1478 (D.C.Cir. 1992).

designed by the Commission -- which may lead to higher rates prospectively -- does not collide with the keystone principle because there is no refund involved.

Paragraph 16 is still another indicator that the Notice has converted the Commission's sharing backstop -- which may result in a PCI adjustment in either direction[11] -- into a refund mechanism that was never part of the Commission's plan. Paragraph 16 contemplates an added step in applying incentive regulation: calculating and applying a credit to cover the PCI-API difference. This proposal suggests the Commission forgot an important step in fashioning its plan. In fact, the Commission did not forget; no additional step is necessary. Applying the formula as written, as well as the policy it expresses, means there is never a need to speak of a credit for the PCI-API difference.

Converting the PCI adjustment arising from the sharing backup mechanism into a refund mechanism as proposed by the Notice would depart from the governing logic of incentive regulation. It was never the purpose of incentive regulation to assure that carrier rates of return would be compelled to operate within a narrowly defined range in each and every year. Assuring that result is the fixation of a rate or return system pursued to the exclusion of all other considerations. All the important benefits identified by the Commission as justifications for incentive regulation are sacrificed by rate of return regulation in order to assure that a carrier does not earn more than a prescribed return in a given period.

The Commission's incentive regulation plan is designed to permit regulators and companies to escape from this mindless rigidity. The sharing backstop was intended to provide protection for the ratepayer if the Commission had selected too low a productivity target without sacrificing the essential objectives of price caps as identified by the Commission. The mechanism by which this is accomplished is a one-time

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[11] *LEC Price Cap Order*, 5 FCC Rcd at 6804-05.

adjustment to the PCI for the following year. The Commission considered proposals for including a refund feature in its plan and for including an annual adjustment known as an automatic stabilizer.[12] The Commission consciously put aside these proposals, deciding that the sharing mechanism would duly protect the public interest. Thus, in the *LEC Price Cap Order*, the Commission formally adopted a backstop mechanism which only included sharing, while excluding the automatic stabilizer, on the grounds that the sharing mechanism was simpler and more flexible. Further, it specified that this sharing mechanism "operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings, as it would in the case of the stabilizer" previously considered.[13] The Commission was convinced to reject the permanent effect of the automatic stabilizer on the grounds presented by GTE's filed Comments, that the stabilizer would create "perverse incentives" which might seriously harm the LECs when they had a productive year.[14] While the Commission adopted the sharing proposal, and rejected the automatic stabilizer, it refused to adopt the other two backstop mechanisms, in particular, a refund.

Now the Notice proposes to make a change in the price cap rules that would amount to reversing the Commission's decision retroactively, *i.e.*, to putting into effect an add-back calculation that would be make the sharing feature tantamount to a refund; and would also be similar to the automatic stabilizer in that it would not be one-time but would necessarily have an impact on the calculations for subsequent years. This is presented in the Notice as a mere clarification, but in fact it would be a fundamental shift in the balances of incentive regulation, as it would be a major step backward toward rate of return regulation.

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[12] *D.87-313 Report & Order*, 4 FCC Rcd at 3215-17.

[13] *LEC Price Cap Order*, 5 FCC Rcd at 6803.

[14] *Id.*

This is demonstrated by the reasons offered by the Notice at paragraphs 11-13 supporting the add-back proposal -- reasons that indicate a profound misunderstanding of incentive regulation. There is no reason whatever to believe the Commission had in mind requiring a direct connection between "[c]hanges in rate of return each year" and "productivity growth relative to the price cap target."[15] "[W]ithout add-back, artificial swings in earnings can occur."[16] This is quite true, and incentive regulation was designed with just that in mind. It is part of the rate of return fixation to demand a smooth earnings pattern year-to-year. Just this kind of over-emphasis on detailed mechanics imposes on regulation the irrationalities the Commission was seeking to escape through price caps.

As for the statement that "add-back appears necessary to the rate of return thresholds applied to determine price cap LECs' sharing obligations and lower adjustment right are those we intended,"[17] the formula specified by the Commission does not contain a reference to an add-back calculation; and the formula as written accomplishes precisely what it was designed to do.

The quoted language of the Notice reflects a spirit totally alien to the driving force behind price caps. Instead of seeking to escape the irrationalities and distortions of price caps, the Notice would embrace and reimpose those irrationalities and distortions in the guise of clarification.

In summary: Grounded on an erroneous premise, the Notice proposes changes in the Commission's incentive regulation plan that conflicts directly with its underlying intent and explicitly stated procedures. The Commission should reject these proposals.

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[15] NPRM at paragraph 11.

[16] NPRM at paragraph 12.

[17] NPRM at paragraph 13.

3. GTE urges the Commission to focus on the governing logic of price caps and how best to achieve the stated objectives of incentive regulation.

The purpose of the sharing mechanism was to make certain that extraordinary productivity gains would be shared with the customer. Thus, under the price caps plan adopted by the Commission, sharing serves as a backstop mechanism for the productivity adjustment. This backstop mechanism is implemented through a one-time PCI adjustment the following year which lowers the cap under which prospective rates are set.

Price caps represents a bold new approach to regulation. Its is designed to assure protection of the public interest while avoiding the pointless complexities and irrational consequences of the rate of return system. To permit a measurement of how well the system is working, and an added degree of protection for the public, the Commission created the sharing mechanism. But this did not change the goals of the price caps program.

Under rate of return regulation, refunds actually reduced cash for the overearning exchange carrier. No such exchange of cash exists under price caps; rather, the cap on prices the exchange carrier will charge in the succeeding tariff year is adjusted in either direction. This is not at all the same thing as saying prices will be reduced, because price reductions (or increases) are dependent on other elements in the price caps process. The sharing mechanism creates a potential future price reduction or increase; it is most emphatically not a refund mechanism. It is not "designed to operate in much the same way as rate of return regulation."[18]

GTE believes the intent of the sharing and LFAM mechanisms in the price cap plan is clear, as are the directions for application of these mechanisms. That the Commission did not change its reporting requirements merely indicated the desire to retain a benchmark for evaluating the results of price caps. Nothing in the price cap

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[18] NPRM at paragraph 8.

orders provides any indication that sharing was to be employed to create refunds as under rate of return regulation rather than its avowed purpose: making appropriate PCI adjustments that would affect prospective rates.

Under price cap regulation, it is improper even to speak of overearnings. Earnings over the upper threshold are shared with the customers through adjustments in the PCI.[19] This is not a question of overcharging the customer; it is evidence that the system is working in that it has produced the beneficial economies that are the target of price caps -- economies that are lost through the irrationalities of rate of return regulation.

In the *LEC Reconsideration Order*, the Commission also indirectly concluded that sharing is not a refund. Several parties filed petitions stating that interest could not be imposed on sharing because it was not an overearnings refund. The Commission rejected the argument, not on the grounds that sharing was a refund, but on the grounds that the Communications Act does not forbid interest in situations other than a refund.[20] Therefore, the Commission indirectly determined it could charge interest on sharing even thought it was not a refund.[21]

In summary: The governing logic of incentive regulation indicates the proposals of the Notice would defeat achievement of the Commission's stated objectives.

4. The direct linkage of rate of return and productivity growth was severed in the adoption of the original price cap indices.

As stated *supra*, sharing was designed as a backstop mechanism for extraordinary productivity gains. In the *LEC Price Cap Order* the Commission specifically stated:

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[19] Indeed the above threshold earnings can be retained since the sharing mechanism only effects future price caps, not necessarily actual prices.

[20] *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2635

> Individual LECs may experience significant variations from the industry productivity norm, not because of their own foresight and efforts but as a result of regional economics or recessions, among other factors. These possible sources of errors in the productivity offset support the adoption of a backstop program....[22]

GTE is concerned about the Commission's statement in the Notice:

> Changes in rate of return each year are used as a measure of productivity growth relative to the price cap target. The amounts of sharing or lower formula adjustment implemented in one year, however, relate to productivity performance in a prior year. Thus, unless add-back occurs, the relationship between rate of return and productivity growth becomes hidden.[23]

The Notice's expressed concern that the add-back calculation is necessary to be able to monitor productivity through observed earnings is the result of faulty reasoning. The direct connection between rate of return (earnings) and productivity was severed with the adoption of the PCI formula. Price cap regulation is premised on the belief that if changes in a firm's output prices are confined to the level of price change in input factors, including productivity gains, the earnings of the firm will be constrained to the same level as under cost of service regulation. However, because there are other incentives and objectives in regulation besides a single-minded focus on limiting carrier profitability. The other objectives include simplification, and efficiency incentives such as a productivity target rather than the individual firm's actual productivity.

The Commission selected the Gross National Product Price Index (GNP-PI) adjusted for estimated average industry productivity differential as a proxy measure of cost change of input factors adjusted for target productivity gains of 3.3 percent. The selection of this formula itself hides the relationship between rate of return and individual productivity growth. Variation in rate of return could come from the input price changes actually experienced as well as from the productivity achieved. In order

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22 *LEC Price Cap Order,* 5 FCC Rcd at 6801.

23 NPRM at paragraph 11.

for the rate of return to reflect achieved productivity the change in the GNP-PI must exactly match the change experienced by the exchange carrier. And, the relationship of earnings and productivity is further obscured when the LEC's actual prices vary from the maximum under the PCI. Moreover, GNP-PI is only a proxy measure itself and in actuality economy-wide productivity may not be precisely reflected.[24]

Further, the calculation of productivity from observed return requires knowledge of the relationship of cost and capital structures.[25] As that relationship changes so will the relationship of return and productivity.

In addition, all voluntary price reductions would need to be backed out or accounted for in some manner, that is Actual Price Indices ("APIs") below PCIs. The timing of these price decreases would also need to be accounted for since they would not necessarily (or probably) match the time period for calculating return. The derivation of productivity from earnings would require that the "Z" factor exogenous adjustments precisely reflect only cost changes not also reflected in the GNP-PI and that the timing of the impacts match.

Arguing for the add-back on the basis of needing it to track productivity is invalid because there is no precise linkage anyway. Applying add-back, particularly as a way of adding "precision", runs counter to the fundamental premises of simplifying regulation and using a form of regulation that provides significant incentives to increase efficiency while giving rate customers reasonable protection from excessive earnings.

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24 In selecting the GNP-PI the Commission recognized this imprecision. *LEC Price Cap Order,* 5 FCC Rcd at 6792-93.

25 The Commission discusses this relationship and notes that it will vary for individual LECS. *D.87-313 Report & Order*, 4 FCC Rcd at 3213-14. The Commission found that "on **average** a LEC will experience **about** a 0.4 percent change in its rate of return for each 1.0 percent change in productivity relative to economy-wide productivity...." *Id.*, emphasis added.

The add-back is a significant regressive step to rate of return regulation the very form of regulation rejected by the Commission when it adopted price caps.[26]

In summary: The direct linkage of rate of return and productivity growth, which was severed in the adoption of the original price cap indices, cannot be restored by the add-back.

5. If sharing is viewed correctly as a productivity backstop and not a refund mechanism, there are no grounds for the Notice's concerns about swings in earnings and earning outside the reasonableness range.

The Commission has two additional concerns about sharing that it believes can only be resolved if add-back is implemented. First, it believes that swings in earnings will occur.[27] Second, without add-back the alleged double-counting of backstop would produce earnings which lie outside the range of reasonableness determined by the Commission.[28]

GTE suggests these concerns are unfounded. The sharing mechanism was not regulation. Indeed, the risk of fluctuations in earnings is placed on LECs under price caps.[29]

GTE suggests concerns about earnings outside the range of reasonableness are unfounded. The FCC in the NPRM Appendix A seems to be concerned with the fluctuation of the rate of return with no change in the underlying costs.

Incentive regulation was designed to permit an escape for regulators and companies from the single-minded focus on rate of return to the exclusion of all other values. The sharing mechanism will affect the price cap; rates will then have to be conformed to the cap – if they are not already in conformity. The resulting revenue and earnings will fluctuate even with no change in the underlying costs. This does **not** equate to earnings being outside of the range of reasonableness.

In summary: These concerns arise from misunderstanding the sharing mechanism, from viewing it as a refund rather than as a backstop for productivity. When the nature of the sharing mechanism is understood, these concerns are resolved.

6. Ruling on the add-back issue should be deferred and included in the four year comprehensive review of the exchange carrier price cap plan.

The scheduled comprehensive four year review of the exchange carrier price cap plan begins at the end of 1993. At that time, the Commission shall consider how well the plan is working and what, if any, changes would be appropriate. GTE suggests the Commission should not make changes in the plan until that comprehensive review is completed.

This is particularly the case for the changes proposed in the Notice which would depart in very fundamental ways from the whole purpose of incentive regulation. Indeed, it could be said these proposals suggest a policy change that would go back to rate of return regulation.

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[29] *D.87-313 Report & Order,* 4 FCC Rcd at 3215-16.

At the very least, the changes in the price caps program represented by the proposals of the Notice would disrupt comparability period-to-period and raise the question of whether incentive regulation is subject to abrupt shifts in reaction to political considerations. The program represents a commitment of both sides. If it comes to be perceived as a program that may be modified in an opportunistic way without regard to its essential governing principles, this could have an adverse effect in the capital markets -- where generally the price caps plan was understood to be a genuine commitment of the agency to a carefully developed plan and the policies upon which the plan was grounded.

In establishing the four-year review period of LEC price cap regulation, the Commission said:

> To provide a fair evaluation of the program, it is also important that the initial period before periodic review and the possibility of major adjustments be long enough for incentives to operate. We believe that a

Accordingly: The Commission should not make changes in the price cap plan until its comprehensive review is completed.

Respectfully submitted,

GTE Service Corporation and
its affiliated domestic
telephone operating companies

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